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SUBJECT: INDONESIA TAKES STOCK OF ECONOMIC REFORMS

¶1. (SBU) Summary. Coordinating Minister for Economics Boediono told a gathering of Embassy and private sector representatives on January 18 that he expects Parliament to pass new investment and tax laws "in the early months of 2007." Minister of Trade Mari Pangestu went further in her description of Parliament's deliberations of the draft investment law, stating that discussions are in the "final phase" and likely to be completed the week of December 18. A Parliamentary plenary session would then pass the law shortly after January 8. Pangestu was uncharacteristically silent on whether the draft law would eliminate Indonesia's investment approval system, a previous Government of Indonesia (GOI) priority. Minister of Finance Sri Mulyani Indrawati described an ambitious reform program at the Ministry of Finance (MOF) in the areas of treasury management, debt management, tax, and customs, but conceded she was disappointed by Parliament's failure to pass the draft tax laws in a speedy fashion. Investment Coordinating Board (BKPM) Chairman Mohammed Lutfi noted that the GOI is in the process of revising and making more generous Indonesia's investment incentive regulations and is using the Batam Special Economic Zone's (SEZ) streamlined investment procedures as a pilot for other SEZs across Indonesia. Boediono made very cautious comments about the possibility of reforming Indonesia's overly rigid severance pay and contract work systems, noting that the GOI is "not close" to consensus. The Director of the University of Indonesia's Institute for Economic and Social Research (LPEM), Dr. Chatib Basri, presented the results of a survey showing little progress on the investment climate between the end of 2005 and mid-2006, a conclusion that surprised few of the business leaders in attendance. End Summary.

¶2. (U) A team of ministers led by Coordinating Minister Boediono and Bank Indonesia (BI) Governor Burhanuddin Abdullah reviewed progress on the GOI's economic reform agenda, as well as plans for 2007, for a group of 150 Embassy and private sector participants on December 18. The GOI scheduled the meeting in response to a request from the co-chairs of the Consultative Group on Indonesia's (CGI) Investment Climate Working Group (the U.S., Japan, European Union, and World Bank). However, the GOI decided to hold the meeting outside the CGI framework, and in addition to approximately 20 CGI member countries or organizations, also invited representatives from a number of domestic and international business groups and the Chinese, Indian, Qatar, Saudi Arabian, Kuwaiti and ASEAN country Embassies.

Positive Macroeconomic Outlook and MOF Reforms

¶3. (U) Boediono, Minister of Finance Sri Mulyani Indrawati, and BI Governor Abdullah provided uniformly upbeat assessments of

Indonesia's macroeconomic situation, noting that GDP growth is rising, public debt and inflation are falling, the Rp/USD exchange rate and overall balance of payments situation are steady, and banking system indicators are improving. However, Boediono noted that Indonesia still needs a "growth push" to create more jobs. The non-oil sector is growing well at approximately a 6.5% rate, he said, but the oil and gas sector suffers from "specific problems," and is stagnant. The GOI "needs to do something" about this situation, he said. Boediono also stated that the GOI is working to stabilize rice prices and will "do whatever it takes" to normalize the situation. Burhanuddin repeated recent BI statements cautioning that the potential exists for increased inflationary pressures in 2007, requiring prudent monetary policy.

14. (SBU) Mulyani provided some details on the ambitious internal reform program underway at the MOF. As part of the GOI's fiscal consolidation efforts, which have seen budget deficits drop from 2.4% of GDP in 2001 to approximately 1% in 2006 and 2007, Mulyani said the MOF is pursuing "fundamental reforms" in its treasury operations. President Yudhoyono created a new Director General for State Treasury position in November as part of an overall restructuring at the MOF. The MOF is working to manage its cash and risk better, and adopt a multi-year budget framework, a Treasury Single Account system, and accrual basis accounting. The MOF is also taking a "disciplined approach" toward contingent liabilities from state-owned enterprise capital injections, infrastructure risk-sharing, Rp 11 trillion (\$1.2 billion) in unpaid value added tax refunds from 1999-2001, and local government borrowing. On the latter, the Mulyani said the MOF will control both the total level of local government borrowing as well as the procedures local governments must follow to issue bonds, including obtaining approval by the Minister of Finance.

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15. (SBU) Internal reforms in the Directorates General for Taxation (DGT) and Customs and Excise (DGCE) are also moving forward, Mulyani said. The MOF has finalized a draft Presidential Decree "radically changing" the structure at DGT from one based on type to tax to one based on functional directors. In response to continuing complaints about the behavior of tax officials, the MOF is also trying to improve governance by modernizing the structure of tax offices, implementing an enhanced code of conduct, and raising discipline and enforcement. Current regulations on civil service conduct are weak, Mulyani said, and the MOF is working closely with the Corruption Eradication Commission (KPK) in cases of suspected misconduct in the DGT. If there are indications that DGT officials have committed acts "close to criminal activity," the KPK will launch an investigation. Mulyani added that she has asked DGT to review the functioning of existing Large Taxpayer Offices (LTOs). Although revenue from these offices has increased on average by 40% a year, 7-10% of complaints from firms covered by LTOs are still related to governance. "This is unacceptable," Mulyani said, and the GOI needs to reduce complaints so it can expand the LTO system further.

16. (SBU) In an effort to improve the functioning of Indonesia's customs clearance system, Mulyani said the MOF is establishing pilot "Major Customs Offices" in Batam and Tanjung Priok port in Jakarta, which together process 60-70% of Indonesia's exports and imports. These offices are similar in concept to the LTOs--they will have more modern organizational structures, and officials stationed at them will receive significantly higher salaries but be subject to much stronger discipline.

Draft Tax Laws: "We're Ready to Discuss Anytime"

17. (SBU) Mulyani noted that although it was unfortunate that Parliament had not yet passed revised taxation procedures, value added tax, and income tax laws, the MOF is ready to discuss the draft laws "anytime, even during the holiday recess." Mulyani appealed to Golkar Parliamentarian and Chairman of the Indonesian Chamber of Commerce and Industry (KADIN) Mohammed Hidayat, who was in attendance, for help in "increasing motivation among Parliament" to pass the law. Boediono said that he hoped Parliament can pass the three tax bills "in the early months of 2007" so that parts of

the laws could be partially implemented in 2007.

Parliament Close to Passing Investment Law

¶8. (SBU) Minister of Trade Mari Pangestu expressed optimism that Parliament would pass the draft investment law soon after it returned from recess on January 8. She reported that consultations between GOI and Parliament on the draft law were nearly complete and that she expected to appear once more before Parliament's Commission VI before Parliament votes on the draft law in a plenary session. Pangestu asserted that the GOI had already made considerable progress in drafting the law's accompanying regulations, including the creation of a clear and concise negative list, and that they would be issued in conjunction with the enactment of the law. (Comment: An international consultant working closely with the Ministry of Trade (MOT) on the negative list had a different view, and told us that the process has a long way to go. With no existing, comprehensive list of investment restrictions, the MOT has received as much as a hundred pages of detail on existing investment restrictions from a number of ministries. The MOT will compile the various lists into one comprehensive document, and then present the cabinet with options for paring down the list of restrictions. This process could take several months. End Comment.)

Investment Incentives/Investment Approval System?

¶9. (U) Investment Coordinating Board (BKPM) Chairman Mohammed Lutfi reported that the GOI is in the process of revising Government Regulation 148/2000 which establishes a set of standard incentives for qualifying investments. Specifically, the draft regulation allows qualifying investors to deduct up to 30 percent of their realized investment from gross taxable income (five percent of the realized investment per annum for the first six years of the project); carry forward losses for up to 10 years; and utilize an expedited depreciation schedule. According to an Indonesian language MOF presentation, the draft regulation would also reduce from 15 to 10 percent the income tax rate on dividends paid outside Indonesia.

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Pangestu explained that the incentives will be available to new investors in selected "pioneer sectors" and regions.

¶10. (SBU) In contrast to previous CGI investment climate meetings, Pangestu made no mention of efforts to transform Indonesia's investment approval system into a streamlined registration regime, an earlier GOI reform goal. Lutfi, however, claimed that the GOI has made considerable progress in reducing the time needed to obtain approvals for starting a business on Batam Island through a newly-established "Integrated Investment Services Center" (IISC). The IISC is a one-stop-shop that houses all GOI agencies responsible for issuing business approvals in Batam, including the BKPM, the MOF, the Ministry of Transmigration and Manpower, the Ministry of Law and Human Rights, the Batam regional government, and the Batam Authority. According to Lutfi, BKPM approvals processed through the Batam IISC now take just one to two days on average. Lutfi also claimed that the Batam IISC now processes approvals for a dozen required permits and licenses in a cumulative 59 days, less than the 97 days in other areas as cited in a 2006 IFC survey.

¶11. (SBU) Pangestu added that her Ministry continued to reform its business regulation and licensing systems and had implemented significant reforms in December 2005 and March 2006. She cautioned, though, that meeting the GOI's target of reducing the number of days it takes to start a business from 150 to 30 days would take time. (Comment: The consultant cited in para eight also told us that when a GOI team had examined the MOT's streamlining of procedures to obtain the Trade Business License (SIUP), a document required of almost all businesses in Indonesia, they had found that the new "streamlined" procedures took significantly longer than the old ones. End Comment.)

Batam Special Economic Zone

¶12. (SBU) Lutfi blamed an IMF-imposed removal of Batam's free trade zone (FTZ) status in 2001 for Batam's recent decline. At its height in 2001, the Batam FTZ accounted for 14 percent of Indonesia's non-oil and gas domestic exports and created over 200,000 new jobs. The export figure had fallen to eight percent by 2005, and Lutfi said the GOI's goal is to lure \$1 billion in new investment in 2007-2010 and create 100,000 new jobs. To reinvigorate the area, Lutfi said the GOI planned to clarify its status, laws and regulations; remove import duties except for consumable goods; create model customs and tax offices; ease labor restrictions; and reduce to 33 days the time it takes to start a business. Pangestu added that the GOI had already established a pilot ASEAN Single Window in Batam -- a one stop service for processing import and export documents -- and that the DGCE would establish the next Single Window would in Jakarta's Tanjung Priok port, Indonesia's busiest. (Comment: We are not sure of the relationship between the ASEAN Single Window initiative and the Major Customs Offices described by Mulyani. End Comment.)

¶13. (U) Pangestu said that the GOI hopes to use Batam as a model for creating similar special economic zones or "areas of excellence" in strategic locations across Indonesia. She noted that it is easier to remove "supply-side constraints" in such small geographical areas than throughout the entire country. Like Batam, each zone would have a single authority that would employ best practices in providing services to investors, such as licensing and permitting, dispute resolution, and import and export procedures. Pangestu said the GOI is still considering where to locate the zones, but is basing its assessment on supporting infrastructure and industries, and access to inputs of production, such as raw materials and skilled labor.

Labor Reform Continues to Flounder

¶14. (SBU) Boediono admitted there has been little progress on labor issues following the July release of a GOI-commissioned study on draft labor legislation by six local universities. Proposed revisions to Indonesia's labor law, especially those related to levels of severance pay and outsourcing, spurred mass labor demonstrations in April and May 2006. The study recommended against the GOI's proposed revisions to the Labor law and suggested adjustments to existing regulations as a better approach to alleviating investor concerns. Boediono suggested that all parties need to come together to discuss these sensitive issues. He quickly

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added, though, that the GOI is "not close" to reaching consensus on the issue, and that progress on labor issues would have to wait for the right moment politically. (Comment: A senior official at the Coordinating Ministry expressed frustration that although the GOI received the University study in July, it has made no effort to publicize the study's recommendations, a clear sign of GOI reluctance to take up labor reforms. End Comment.)

Movement on Infrastructure Priorities

¶15. (SBU) Boediono reiterated the importance of infrastructure investment to the GOI. Although overall investment remains low, spending on infrastructure is rising. Boediono was optimistic on the passage of transportation, postal, electricity, and energy reform laws reducing or eliminating SOE monopolies in these sectors and opening them up to private investment. Boediono assured investors, "the laws are in a high level committee of the DPR" and expected to pass in the early part of 2007. He also reiterated the GOI's commitment to bringing a list of 10 GOI model projects to completion next year, an important step for investor confidence. However, he acknowledged that almost two months after the November 1-3 Infrastructure Forum, none of the model projects are ready for tendering. Mulyani also reiterated her intent to scrutinize government support for "non-compliant and high profile" projects handled outside of the formal public private partnership system established by Presidential Decree 67/2005. Although not compliant with Decree 67/2005, Mulyani noted that these projects are not necessarily bad, and need to be reconciled with the Decree 67

framework. She urged participants not to view GOI support for these projects as a deviation from "good or best practices." (Comment: Mulyani was likely referring to the \$650 million Jakarta Monorail project, which the GOI has reportedly awarded a modest ridership guarantee capped at \$25 million annually. However, newspaper reports indicate that investors in the project continue to seek access to more GOI funds. End Comment.)

Survey Shows Stagnant Investment Climate

¶16. (SBU) The University of Indonesia's LPEM presented the conclusions of the third and last round of its World Bank-funded Investment Climate Monitoring survey. LPEM conducted the survey from June through August of this year, and their results show a marked decrease in business confidence in the investment climate from the previous survey taken at the end of 2005. The biggest constraints to business remain macroeconomic stability, policy uncertainty, and corruption. However, the survey showed a significant increase in the number of manufacturers concerned with electricity supply and transportation infrastructure, due to frequent brownouts and transportation delays.

¶17. (U) According to the survey, labor indicators (labor regulations, labor skills/education) also continue to worsen with severance pay and lay-off procedures seen as the biggest obstacles. Respondents also noted that Indonesia's labor laws reduce the competitiveness of manufacturing firms and that both the number and cost of labor disputes are rising. The survey noted that the majority of labor problems affect large, export-oriented manufacturing firms in sectors where Indonesia has the potential to be regionally competitive. The survey also noted some areas of improvement in the customs and trade regulations at both the local and central government level. Firms reported decreased times and informal payments for customs clearance.

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